ONSHORE TAX SHELTERS: HOW SMALL BUSINESSES CAN BE HURT BY FOLLOWING BUSINESS FORMATION AND INVESTMENT LAWS

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I. INTRODUCTION

Actor Wesley Snipes was convicted for tax evasion for failing to pay federal income taxes for several years.[1] Despite earning more than $37 million between 1999 and 2004, Snipes did not pay federal income taxes, alleging that the income should not be classified as income under the Internal Revenue Code ("IRC").[2] Snipes also justified his lack of tax payments on other theories, including that he was a "non-resident alien to the United States," that "a taxpayer is defined by law as one who operates a distilled spirit plant," and "that as a 'fiduciary of God, who is a nontaxpayer,' he was a foreign diplomat who was not obliged to pay taxes."[3] Snipes believed he had found a loophole in the system,[4] when in fact he was misinterpreting the law by alleging he did not have to pay income taxes. Though this is a case of blatant tax evasion, the abuse of tax shelters can have similar results.

The ability of small business owners to receive the tax benefits they are entitled to is essential for job creation. These benefits can come through state and federal laws, including the tax code and business formation laws. There is, as with any imperfect legal system, a potential for abuse of these tax benefits and business formations. Some people will use the formation and tax "loopholes" to attempt to hide personal funds or other illegal

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[1] United States v. Snipes, 611 F.3d 855, 873 (11th Cir. 2010).

[2] *Id.* (citing I.R.C. § 861 (2006)). Snipes believed that the money he made should not be treated as gross income because it was not specifically listed under this section of the code. *Id.*

[3] *Snipes*, 611 F.3d at 860. When Snipes consulted his regular tax attorney, he was advised that he did have to pay his taxes. He was dismissed as a client after still refusing to pay. *Id.*

[4] *Id.* When Snipes tried teaching his employees about the plan, one employee questioned his theory. He then "ordered her to leave his house, later telling her that he was 'disappointed' in her and that if she was 'not going to play along with the game plan,' she should find another job." *Id.*

activities.[5] As a result of this abuse, many different laws have been proposed to make abusive tax shelters more difficult to orchestrate.[6] As more laws are passed to combat the minority of people attempting to avoid paying taxes, it will become overly costly and more difficult for new entrepreneurs to create businesses. Entrepreneurs will face increased scrutiny from the Internal Revenue Service ("IRS") and other federal regulators in their effort to create new businesses.[7]

This article will first discuss how people use abusive tax shelters then discuss several legitimate tax shelters, including corporation soles, trusts, and limited liability companies ("LLCs"), in an effort to reduce personal tax liability. The article will also discuss money laundering, because many laws combat both international money laundering and onshore tax shelters.[8] There have been several laws passed to try to combat this activity,[9] and more laws have been proposed to tackle the issue.[10] The article will conclude with several recommendations for how the government can maintain both competing interests: the small business owner's interest in reducing business formation and investment costs and the government's interest in stopping illegal use of tax breaks designed for only certain types of businesses or other entities.

II. WHAT IS AN ABUSIVE TAX SHELTER?

A. *Current Definitions*

Tax shelters are defined differently by several different groups. The American Bar Association ("ABA") defines a tax shelter as:

> [A]n investment which has a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income

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[5] Garrison Grawoig DeLee, *Abusive Tax Shelters: Will the Latest Tools Really Help?*, 57 S. CAL. L. REV. 431, 464 (1984).

[6] *See, e.g.*, Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. § 2009 (2009). The Incorporation Transparency Act is a proposed bill that will require the disclosure of the beneficial owners of corporations and LLCs. *Id.* The bill is also supposed to be a means of preventing terrorism and illegal crime, but it will apply to all owners, even those that have no illegal goals. *Id.* § 4

[7] *See* Stop Tax Haven Abuse Act, S. 506, 111th Cong. §§ 306–07 (2009) (increasing communication between the Securities and Exchange Commission ("SEC"), Treasury, federal bank regulators, or Public Company Accounting Oversight Board ("PCAOB") in order to prevent the use of tax havens).

[8] *Id.*

[9] *See* Racketeer Influenced and Corrupt Organizations (RICO) Act, 18 U.S.C. §§ 1961–63 (2006); Money Laundering Control Act, 18 U.S.C. § 1956 (2006).

[10] S. 506; S. 569.

> from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.[11]

In contrast, Congress defines a tax shelter as "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax."[12] These definitions vary in several respects. The ABA focuses on "attributes that reduce the income tax payable on income from sources outside the shelter."[13] The congressional definition is instead focused on the "principal purpose of an entity's existence" when deciding how to punish the tax avoidance or evasion.[14] Excise taxes are also not included in the congressional definition.[15] The application of these differing definitions affects how people set up abusive tax shelters.

An abusive tax shelter is created when a tax promoter promises tax benefits for individuals or small businesses that, though illegal, may be found legitimate during an IRS audit.[16] IRS enforcement works to avoid tax evasion by shutting down the promotion of abusive tax shelters.[17] The five elements of an abusive tax shelter are:

> (1) the defendants organized or sold, or participated in the organization or sale of, an entity, plan, or arrangement; (2) they made or caused to be made, false or fraudulent statements concerning the tax benefits to be derived from the entity, plan, or arrangement; (3) they knew or had reason to know that the statements were false or fraudulent; (4) the false or fraudulent statements pertained to a material

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[11] DeLee, *supra* note 5, at 433 (citing ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 346 (revised 1982), *reprinted in* 68 A.B.A. J. 471, 471 n.1 (1982)). There are also exceptions from these tax plans, including municipal bonds, annuities, and "real estate where it is anticipated that deductions are unlikely to exceed gross income from the investment in any year, and that any tax credits are unlikely to exceed the tax on the income from that source in any year." *Id.*

[12] *Id.* (citing I.R.C. § 6661(b)(2)(C)(ii) (1982)).

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.* at 437.

[17] *Id.*

> matter; and (5) an injunction is necessary to prevent recurrence of this conduct.[18]

In *United States v. Schulz*, the court held that the defendant promoted an abusive tax shelter based on the test administered by the IRS.[19] Robert Schulz participated in the organization of a plan to avoid paying personal taxes by giving people forms to avoid the withholding of taxes by their employers.[20] The defendant made false statements about the tax benefits of his proposed plan, including that the Sixteenth Amendment was not properly ratified.[21] The defendant did all of this knowing that personal income taxes were required by law.[22] Furthermore, the statements he made about not being required to pay taxes pertained to a material matter.[23] A material matter is a subject "which would have a substantial impact on the decision-making process of a reasonably prudent investor and includes matters relevant to the availability of a tax benefit."[24] The necessity of an injunction for abusive tax shelters relies on:

> (1) the gravity of harm caused by the offense; (2) the extent of the defendant's participation; (3) the defendant's degree of scienter; (4) the isolated or recurrent nature of the infraction; (5) the defendant's recognition (or non-recognition) of his own culpability; and (6) the likelihood that defendant's occupation would place him in a position where future violations could be anticipated.[25]

The court decided that injunctive relief was warranted in this case because all of these factors were met by Schulz.[26]

B. *Recently Passed Legislation About Abusive Tax Shelters*

The American Jobs Creation Act of 2004 was also designed to prevent abusive tax shelters.[27] This law requires all taxpayers to report all

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[18] United States v. Schulz, 529 F. Supp. 2d 341, 346 (N.D.N.Y. 2007) (citing I.R.C. § 6700 (2006)).
[19] *Id.* at 357.
[20] *Id.* at 348.
[21] *Id.* at 349 (citing United States v. Carley, 783 F.2d 341, 344 (2d Cir. 1986) ("[T]here is no question but that Congress has the authority to impose an income tax.")).
[22] *Id.* at 350. Schulz admitted he knew the tax laws. *Id.*
[23] *Id.* at 352.
[24] *Id.*
[25] *Id.* (citing United States v. Estate Pres. Servs., 202 F.3d 1093, 1105 (9th Cir. 2000)).
[26] *Id.* at 354.
[27] I.R.C. § 6707A(a) (2006).

transactions, even if the transaction occurs overseas.[28] The law also allows the IRS to take a broader approach in preventing the promotion of abusive tax shelters or aiding a taxpayer in understating tax liability.[29] Under the law, these tax shelter transactions will not have all of the confidentiality standards that had been available in the past.[30]

Even after the law's enactment, there is still a reasonable exception for reportable transaction understatements.[31] This exception is only applicable when the relevant facts have been disclosed and there was substantial authority for the treatment that was "reasonably believed" to be proper.[32] Reasonable belief requires that the tax treatment is based upon the facts of the tax treatment and the likelihood of success on the merits, without taking into account the chances of an audit.[33]

Some tax advisors will not be able to give advice pertaining to tax shelters.[34] A participant in a tax shelter cannot reasonably believe the opinions of an advisor that:

> (I) is a material advisor . . . and participates in the organization, management, promotion, or sale of the transaction or is related . . . to any person who so participates, (II) is compensated directly or indirectly by a material advisor with respect to the transaction, (III) has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained, or (IV) as determined

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[28] *Id.* A reportable transaction is defined as "any transaction with respect to which information is required to be included with a return or statements because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." *Id.*

[29] *New Tax Law Provisions Enacted to Combat Abusive Tax Shelters*, IRS (Mar. 31, 2010), http://www.irs.gov/businesses/article/0,,id=149707,00.html.

[30] *Id.* Confidentiality could have been previously protected by attorney-client or accountant-client privileges, but this law circumvents that protection. *Id.*

[31] I.R.C. § 6664(d) (2006).

[32] *Id.* § 6664(d)(1).

[33] *Id.* § 6664(d)(3)(A). This section states the following:

> (i) is based on the facts and law that exist at the time the return of tax which includes such tax treatment is filed, and (ii) relates solely to the taxpayer's chances of success on the merits of such treatment and does not take into account the possibility that a return will not be audited, such treatment will not be raised on audit, or such treatment will be resolved through settlement if it is raised.

Id.

[34] *Id.* § 6664 (d)(3)(B).

> under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.[35]

Certain types of advice will also not be allowed, even if from an advisor who qualifies to give advice.[36] The opinion cannot be reasonably believed if that opinion is based on unreasonable facts, there is unreasonable reliance on those facts, not all relevant facts are considered, or any other requirement made by the Secretary of Treasury is violated.[37] Despite the presence of abusive tax shelters, tax shelters are still commonly used for legitimate purposes, including the formation and investment decisions of small businesses.

III. HOW ARE LEGITIMATE TAX SHELTERS SUBJECTED TO ABUSE?

There are several legitimate purposes for tax shelters. Tax shelters were drafted into law in order to help different organizations limit tax liability.[38] Over time, people have attempted to "conceal taxable income by exploiting gaps in state business-formation laws that allow hidden ownership or control."[39]

The IRS released the "Dirty Dozen" for tax evasion scams in 2004, which was a list of illegal tax scams.[40] The list of twelve potential tax

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[35] *Id.* § 6664(d)(3)(B)(ii)(I)–(IV). A material advisor is a person "(i) who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (ii) who directly or indirectly derives gross income in excess of the threshold amount . . . for such aid, assistance, or advice." I.R.C. § 6111(b)(1)(A)(i)–(ii) (2006). The threshold amount is $50,000 for a reportable transaction where substantially all the tax benefits are for natural persons, or $250,000 for any other case. *Id.* § 6111(b)(1)(B)(i)–(ii).

[36] I.R.C. § 6664(d)(3)(B).

[37] *Id.* Under I.R.C. § 6664 (d)(3)(B)(iii)(I)–(IV), an opinion is disqualified if it: "(I) is based on unreasonable factual or legal assumptions . . . (II) unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person, (III) does not identify and consider all relevant facts, or (IV) fails to meet any other requirements as the Secretary may prescribe." *Id.*

[38] Tom Herman, *IRS Cracks Down on Dodgers Who Use Onshore Tax Havens*, WALL ST. J., Dec. 6, 2006, at D2. These goals are achieved through the use of corporations, trusts, LLCs, or other business structures. *Id.*

[39] *Id.* Former Senator Norm Coleman stated "[T]he absence of ownership disclosure requirements and lax regulatory regimes in many of our states makes U.S. shell companies attractive vehicles for those seeking to launder money, evade taxes, finance terrorism, or conduct other illicit activity anonymously." *Id.*

[40] I.R.S. News Release IR-04-26 (Mar. 1, 2004).

scams included some activities that are never legal,[41] as well as other scams that exploit or misinterpret the actual tax law.[42] Several of these scams involve legitimate interests for entrepreneurs, including the use of corporation soles, trusts, LLCs and employment tax withholdings.[43]

A. *Corporation Sole*

Corporation soles are "formed for acquiring, holding, or disposing of church or religious society property, for the benefit of religion, for works of charity, [or] for public worship."[44] States create corporation sole laws to give tax exempt status to qualifying religious groups.[45] A corporation sole is designed to allow the leader of a religious organization to ensure that the organization can continue after the death of the current leader.[46] Corporation sole laws were created in order to avoid the personal holding of a religious organization, which could then be destroyed upon the death of the leader.[47] As of 2004, corporation sole incorporation was allowed in only sixteen states.[48]

An illegal corporation sole is usually created when a person (or a tax shelter promoter working on behalf of a person) tries to reduce his or her total deductions by setting up a corporation sole under the guise of being a "bishop."[49] The taxpayer believes that this structure allows money to be put into the corporation sole to reduce personal income tax liability.[50] The increase of corporation sole promotion has led to a "significant influx of suspicious corporation sole applications" coming especially from both

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[41] *Id.* The scams with no legal basis listed by the IRS include "Claim of Right Doctrine," "Employment Tax Evasion," "African Americans Get a Special Tax Refund," "Improper Home-Based Business," "Identity Theft" and "Share/Borrow EITC Dependents."

[42] *Id.* These scams include "Misuse of Trusts," "Corporation Sole," "Offshore Transactions" and the "Americans with Disabilities Act." *Id.*

[43] *Id.*

[44] NEV. REV. STAT. § 84.010 (2009).

[45] William W. Bassett et al., *Development, in* 1 RELIGIOUS ORGANIZATIONS & LAW § 3:61 (West 2009).

[46] I.R.S. News Release, *supra* note 40.

[47] Bassett et al., *supra* note 45.

[48] *Id.*

[49] I.R.S. New Release IR-2004-42 (Mar. 29, 2004), *available at* http://www.irs.gov/newsroom/article/0,,id=121566,00.html. A "bishop" is used to connote a religious leader. *Id.* Promoters encourage using "bishop" to show that the corporation sole is a religious organization. *Id.*

[50] *Id.*

Washington and Utah.[51] Utah legislators have gone so far as to ban any future corporation sole filings.[52]

In a recent case, *United States v. Gardner*, a woman and her husband were barred from promoting corporation sole incorporation and other business formations and investment strategies.[53] Elizabeth Gardner promoted the use of corporation soles as a way of reducing personal tax liability.[54] She set up trusts, LLCs, and corporation soles for clients to allow them to hide taxable income.[55] The law allows donations to a corporation sole, but the federal taxes must first be paid on the income.[56] Assignment of income by a taxpayer is plainly ineffective to shift tax liability.[57] Also, a taxpayer is not allowed to make contributions to a legitimate religious organization or other charity, which that taxpayer owns and controls.[58] This promotion violated § 6700 of the IRC because Gardner and her husband knew or had reason to know they were making a false or fraudulent statement about a material matter when promoting the tax shelters.[59] Both Gardner and her husband had extensive tax code knowledge that should have alerted them that their clients were not entitled to the benefits of the tax shelters they were promoting.[60]

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[51] Bassett et al., *supra* note 45.

[52] *Id.* There were fears during the legislature debate that this overarching solution was too "drastic," and instead caused the honest and dishonest to be equally punished. *Id.* Despite these fears, the amendment was passed. *Id.*

[53] United States v. Gardner, No. CV05-3073-PCT-EHC, 2008 WL 906696, at *1 (D. Ariz. Mar. 21, 2008).

[54] *See id.*

[55] *Id.* at *3–4 (Under Nevada law, a corporation sole is "'for acquiring, holding or disposing of church or religious society property for the benefit of religion, for works of charity, and for public worship.'") (alterations omitted).

[56] *See id.* at *2 (citing Pfluger v. Comm'r, 840 F.2d 1379, 1381 (7th Cir. 1988)).

[57] *Id.* at *3.

[58] *Id.* at *2 (citing I.R.C. § 170(c)(2)(C) (2006)).

[59] *Id.* at *5. I.R.C. § 6700 punishes any person who organizes or assists in organizing a business entity, plan, arrangement, or participates in any sale, direct or indirect, of any interest in a plan or arrangement that allows anyone to make:

> (A) a statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or (B) a gross valuation overstatement as to any material matter.

I.R.C. § 6700 (2006).

[60] *Id.*

B. *Trusts*

Many tax shelter promoters also use trusts as a means of reducing federal income tax.[61] Trusts are taxed separately from individual income, but the money in trusts still may be taxed.[62] The income from these trusts will still be taxed in forty-three states and the District of Columbia.[63]

For tax purposes, there are three types of trusts: simple trusts, complex trusts, and grantor trusts.[64] Simple trusts distribute all income currently and make no distributions to charity or principal distributions.[65] This type of trust allows for a deduction equal to the distribution within the year.[66] Complex trusts are allowed to accumulate income and make discretionary distributions, including donations to charity.[67] The trust does not actually have to accumulate income to be a complex trust; the fact that it can accumulate income will suffice.[68] In a grantor trust, "the grantor or another person is treated as the owner of trust assets for federal income tax purposes."[69] This means that the calculation of taxable income and credits of the grantor, the income, deductions, and credits of the trust are included.[70] The other items of the trust are not taxed solely because the grantor is in charge of the trust.[71]

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[61] I.R.S. News Release, *supra* note 40, at 1.

[62] Jeanne Newlon, *State Income Taxation of Trusts*, EST. PLAN. COURSE MATERIALS ALI-ABA 621, 623 (June 2010).

[63] *Id.* at 624. Even if the trust is formed in one of the seven states that do not tax income from trusts, the other forty-three states may still be able to tax the income attributable to the trust.

[64] *Id.* at 623.

[65] *Id.* There are three requirements needed in order to qualify for a simple trust:

> (1) [t]he trust agreement must require that all of the trust's income be distributed currently; (2) [t]he trust agreement must not provide that any amounts are to be paid, permanently set aside or used for charitable purposes; and (3) [t]he trust must not distribute any amounts other than the required income distribution.

I.R.C. § 651(a) (2006).

[66] I.R.C. § 651(a).

[67] Newlon, *supra* note 62, at 621–22 ("A complex trust is any trust that is not a simple trust.").

[68] *Id.* at 621.

[69] *Id.* at 622 (citing I.R.C. § 671(a) (2006)).

[70] I.R.C. § 671.

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are

The taxation of trusts can differ in each state.[72] The initial taxation will be determined based on how and where the trust was formed and where the trustee and beneficiary reside.[73] There are only seven states that do not impose an income tax against trusts.[74] Even when a trust has been created in these states, any one of the other forty-three states may still impose some kind of tax on the beneficiaries or investors in the trust.[75] Grantor trust rules differ among states as well.[76]

There are several general rules to follow for deciding how a trust should be taxed. One rule is that if the trust was created under a will or inter vivos by a resident of the state, or is administered in that state, it may be taxed in that state.[77] Another is that if the trustee or a current beneficiary is a resident of a state, then the trust can be taxed in that state as well.[78]

People who promote these abusive trusts promise that trust income will not be subjected to tax.[79] This results in people investing more money in trusts and being subjected to both individual and trust taxes.[80] Despite the legitimate uses of trusts to shift tax liability,[81] tax shelter promoters encourage using trusts to eliminate or reduce personal income tax liability altogether.

One way promoters have tried to abuse trusts is through a common trust fund ("CTF").[82] In this plan, a CTF is created that provides for profit and loss valuation every month.[83] Grantor trusts invest in the CTF, which will then invest the income in foreign currencies.[84] The CTF will then sell the

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> attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

Id.

[71] *Id.* ("No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust . . . .").

[72] Newlon, *supra* note 62, at 623.

[73] *Id.*

[74] *Id.* at 622. The seven states are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

[75] *Id.*

[76] *Id.* ("Most states do follow the grantor trust rules of the Internal Revenue Code. However, neither Pennsylvania nor Tennessee recognizes grantor trust status.").

[77] *Id.* at 623.

[78] *Id.*

[79] I.R.S. News Release, *supra* note 40, at 1.

[80] *See id.*

[81] Newlon, *supra* note 62, at 622.

[82] Rev. Rul. 2003-91, 2003-2 C.B. 347.

[83] *Id.*

[84] *Id.*

investments with gains and allocate the profits to the investors after each month.[85] After this gain is distributed, a taxpayer wanting a tax loss invests a large amount (around eighty percent of the CTF value) through a different grantor trust.[86] The losses from the CTF investments will then be distributed according to the investment, so the newly invested trust can show an artificial loss on its tax return.[87]

Losses based on earlier investments in a CTF are not allowed to be taken as losses on an income tax return.[88] These losses are not allowed because the objectives of the investment in the CTF were not for a non-tax purpose and there was no reasonable expectation to profit off of the investments for the new investor.[89] If the CTF does not even fit into the description of a common trust fund, the IRS can recharacterize the CTF as a partnership and allocate the losses and profits accordingly.[90] By classifying the investment as a partnership, the individual investor will be taxed on the share of the partnership investment on his or her personal income tax return.[91] Participants in these plans, even if they did not organize the plans, will be penalized by the IRS and will be forced to pay back taxes and penalties.[92]

C. *Limited Liability Companies*

An LLC is the preferred form for most new businesses. It offers the pass-through tax benefits of a partnership with the limited liability of a corporation. There is only a single tax of an LLC, as opposed to the double tax for corporations.[93]

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[85] *Id.*

[86] *Id.*

[87] *Id.* This loss distribution is governed by § 1.584-2(c)(2) of the Income Tax Regulations.

[88] Rev. Rul. 2003-91, 2003-2 C.B. 347.

[89] *Id.* The initial investments in foreign currencies are designed to offset each other, thus resulting in some investments increasing in value and others inherently decreasing in value.

[90] *Id.* In order to be classified as a common trust fund, the fund must conform to all rules and regulations and which is "exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank . . . ." I.R.C. § 584 (2006).

[91] *See* I.R.C. § 704 (2006).

[92] Rev. Rul. 2003-91, 2003-2 C.B. 347. For instances where the IRS has penalized the participant CTFs, see ACM P'ship v. Comm'r, 157 F.3d 231, 260 (3d Cir. 1998); Smith v. Comm'r, 78 T.C. 350 (1982); and Fox v. Comm'r, 82 T.C. 1001 (1984).

[93] For a summary of the double tax in corporations, see Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009).

Each state has different requirements for the formation of an LLC. In Delaware, the LLC requires the name of the incorporator, the name of the LLC, the purpose of the LLC and where the business will be located.[94] In Nevada, the LLC has to file its name, the file number, the names and addresses of managers (or managing members), the registered agent requirements and a signature verifying the truth of the statements.[95] Nevada has been the subject of increased attention since the system has been the target of frequent abuse.[96]

The exploitation of business formation laws and the promotion of these business forms as a means of avoiding tax liability has become a growing problem. Under Delaware law, the true beneficiaries of a LLC do not always need to be identified when forming an LLC.[97] Only a manager or an agent needs to be identified in the certificate of incorporation.[98]

One case in California has shown that an LLC can be created for a specified purpose, but the IRS can reclassify the form of the business if the law requires.[99] An LLC was created in order to create an artificial tax loss for the single member, Randall Thompson.[100] Thompson made a deal with Deutsche Bank that each would sell bonus coupons to each other for roughly $20 million.[101] Thompson liquidated his interest in the LLC and claimed a short-term capital loss on his tax return of $21 million.[102] He counted the loan and coupon purchase as losses because the coupon "call"

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[94] DEL. CODE ANN. tit. 5, § 731(b) (2010) (stating the certificate of incorporation required for an LLC).

[95] NEV. REV. STAT. § 86.263 (1)(a)–(f) (2010). A registered agent is required to state:

> (a) [t]he name of the represented entity's commercial registered agent; or (b) [i]f the entity does not have a commercial registered agent: (1) [t]he name and address of the entity's noncommercial registered agent; or (2) [t]he title of an office or other position with the entity if service of process is to be sent to the person holding that office or position, and the address of the business office of that person.

NEV. REV. STAT. § 77.310 (2010).

[96] Herman, *supra* note 38, at D2.

[97] *See* DEL. CODE ANN. tit. 5, § 731(b).

[98] *Id.* This assumes a manager-managed LLC, as opposed to a member-managed LLC.

[99] RJT Invs. X v. Comm'r, 491 F.3d 732, 735 (8th Cir. 2007).

[100] *Id.* at 734.

[101] *Id.* These coupons were never actually redeemed, but they were designed to function like offsetting call options. *Id.* at 734 n.2. Thompson's coupons were redeemable only if the exchange rate for the pound was less than or equal to $1.4052, while Deutsche bank's coupons did not specify an exchange rate.

[102] *Id.* He used this loss to shelter income on which he would have had to pay taxes. *Id.*

right had been assigned to the LLC.[103] The IRS requested that Thompson's organization, RJT Investments (RJT), be classified as a partnership instead of an LLC.[104] The United States Tax Court declared the LLC was a "sham, lacked economic substance and was formed and/or availed of to artificially overstate the basis of the interest of Randall Thompson . . . for purposes of tax avoidance."[105] The income from the purported LLC was treated as a partnership interest, and the value of the assets in RJT (the coupons) were counted towards Thompson's individual income tax return.[106] These types of sham transactions were also classified as partnership items in several other cases.[107]

In an effort to combat the abuse of LLCs, Congress has tried to require that the beneficial owners of LLCs identify themselves.[108] There are several problems with this mandatory disclosure. First, there could be legitimate reasons for hidden ownership in an LLC.[109] Second, this system defeats the purpose of allowing for limited liability because control can differ by the type of LLC and the state of incorporation.[110] Even though the proposed laws would be a federal statute, if passed, the states would still be

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[103] *Id.*

[104] *Id.* at 734–35.

> [T]he IRS issued a notice of Final Partnership Administrative Adjustments ("FPAA") to RJT's 1065. Issuing a FPAA allows the IRS to make the specified adjustments to partnership filings and impose penalties for misrepresentations that result in the underpayment of taxes by individual partners should relevant parties not challenge the adjustments.

Id.

[105] *RJT Invs. X*, 491 F.3d at 735 (quoting RJT Invs. X v. Comm'r, No. 011769-05, 2006 WL 2504035 (T.C. Apr. 18, 2006)).

[106] *Id.* at 736 (Thompson argued that the language of the statute should not permit this determination, but the circuit court denied this argument).

[107] *See* Weiner v. United States, 389 F.3d 152, 157 n.3 (5th Cir. 2004); Slovacek v. United States, 36 Fed. Cl. 250, 255 (1996). *See also* River City Ranches #1 Ltd. v. Comm'r, 401 F.3d 1136, 1143–44 (9th Cir. 2005).

[108] Stop Tax Haven Abuse Act, S.506, 111th Cong. §§ 306–07 (2009).

[109] J.W. Verret, *Terrorism Finance, Business Associations, and the "Incorporation Transparency Act,"* 70 LA. L. REV. 857, 891 (2010) (stating "the next Pixar may find it impossible to develop its product under the spotlight of public knowledge that someone like Steve Jobs is a principal investor."). Privacy could also be vital for executive recruitment, especially when there is a politically sensitive project. *Id.*

[110] *Id.* at 892. "Many LLCs also permit free assignment of ownership rights and facilitate a divergence between ownership and assignment of financial rights." *Id.* at 893. Also, the difference between member-managed and manager-managed LLCs makes it difficult to determine who is actually in control. A member-managed LLC will have several owners all working together, so nobody can stand out above the rest as necessarily controlling.

allowed to pass legislation to keep ownership information private, potentially making the federal statute irrelevant.[111] This law would unnecessarily increase business formation costs in an effort to prevent the actions of a small minority.[112] There are many other ways to prevent people from organizing sham LLCs, including punishing the promoters of these tax plans and introducing more regulation about who can promote tax shelters of any kind. Increased levels of education would also help reduce the unintentional use of sham LLCs by entrepreneurs.

D. *Employment Tax Withholdings*

Employers must withhold and pay taxes for their employees.[113] Failing to withhold these taxes could result in federal prosecution.[114] There are several schemes that have been used to avoid employment tax liability: pyramiding, employment leasing and paying employees in cash.[115] Pyramiding is when a business withholds taxes from its employees but intentionally fails to remit them to the IRS.[116] These companies can then file bankruptcy to avoid paying the debt and start a new business with a new scheme.[117] Employment leasing involves contracting with outside businesses to handle all administrative, personnel, and payroll concerns for employees.[118] This scheme is abused when employee-leasing companies fail to pay employment taxes to the IRS, instead using them for personal or business expenses.[119] Paying employees in cash is a common way of avoiding taxes.[120] This usually results in lost tax revenue for the government and the loss or reduction of future social security or Medicare benefits for the employee.[121] Filing false payroll tax returns is a blatantly illegal scheme, but some promoters try to convince people to try the scheme anyway.[122] Those entrepreneurs trying to limit their tax liability should not consider an employment tax scheme that seems counterintuitive to even the most basic understanding of tax laws. Those people trying to avoid

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[111] *Id.* at 890.
[112] *Id.* at 864.
[113] I.R.S. News Release, *supra* note 40.
[114] *Id.*
[115] I.R.S. News Release, IR-2004-47 (Apr. 5, 2004), *available at* http://www.irs.gov/newsroom/article/0,,id=122521,00.html.
[116] *Id.* Pyramiding is always an illegal system.
[117] *Id.*
[118] *Id.* Employment leasing can be legal.
[119] *Id.* These companies can then dissolve, leaving millions in employment taxes unpaid.
[120] *Id.* It is technically legal to pay somebody in cash, but the employment taxes still need to be taken into account.
[121] *Id.*
[122] *Id.*

payment of taxes may also try to use some form of money laundering in their plans.

In a recent case in California, *Medlock v. United States*, the owner of a daycare attempted to avoid paying unemployment taxes.[123] The IRS sent a "Notice of Intent to Levy" to Medlock regarding her failure to pay both federal unemployment taxes and federal insurance contribution taxes.[124] At the time the notice was filed, Medlock had been assessed tax liabilities for just under $200,000.[125] Despite an earlier investigation, Medlock continued to lie about her payment of these taxes for some time.[126] Medlock continually avoided the situation when the IRS tried to contact her by alleging that she was trying to sell the day care business.[127] It was determined that Medlock had "signed up with [P]aychex,[128] but never deposited money so [P]aychex could make Federal Tax Deposits on time or at all and file returns."[129] Despite her alleged willingness to compromise with the IRS,[130] she continually filed either late or incorrect forms.[131] The IRS levied other pieces of property and, eventually, forced her to sell the company.[132]

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[123] Medlock v. United States, 325 F. Supp. 2d 1064, 1066 (C.D. Cal. 2003).

[124] *Id.* These taxes were required under the Federal Unemployment Tax Act ("FUTA") and the Federal Insurance Contribution Act ("FICA"). *Id.*

[125] *Id.* at 1070. Medlock's exact assessed tax liability at the time of levy was $199,901.58. The notice only included $25,582.50, because it was only based on a few years of tax withholdings.

[126] *Id.* at 1071. An August 17, 1998 letter referred "to the fact that Medlock's return for the period ended June 30, 1998 erroneously reports 'deposits in the full amount of taxes owed.'" Medlock later admitted that this was false and that the payroll company did not make the deposits she believed they had made.

[127] *Id.* at 1071–72. "Medlock has been suggesting that proposal for almost *five (5) years now*, including during the nearly sixteen (16) month duration of this CDP litigation." *Id.*

[128] Paychex is an organization that provides payroll and human resource information for other companies. For more information, see PAYCHEX, http://www.paychex.com/ (last visited Mar. 29, 2011).

[129] *Medlock*, 325 F. Supp. 2d at 1074.

[130] *Id.* Medlock attempted to settle with the IRS in April of 2000, for $10,000 "in full satisfaction of her unpaid employment tax liabilities for all tax quarters from the period ended December 31, 1992 to September 30, 1999." *Id.*

[131] *Id.* The IRS "eventually returned that offer to Medlock as 'unprocessable' because she had failed to file Form 941 tax returns for the quarterly periods ended March 30, 2000 and June 30, 2000." As a result of these failures to file the proper forms, the "IRS issued the Notice of Intent to Levy to Medlock for the subject periods." *Id.*

[132] *Id.* at 1078 ("Appeals Officer Rich did not abuse her discretion in determining that waiting for an additional unknown, indeterminate period of time for Medlock

This case demonstrates the high level of scrutiny applied to cases on appeal for tax reasons. There are several different tests that can be applied by an appellate court in reviewing a tax case. In one test, the court will analyze the decision made by the IRS as an agency of the government. This will result in an extremely high level of deference and a low level of scrutiny.[133] These cases require the court to go through a two-step process. First, the court must determine whether Congress has expressly given power to the agency.[134] If so, the decision of the agency will stand unless it is "arbitrary, capricious, or manifestly contrary to the statute."[135]

If the court's decision is being analyzed, the appellate court will review the decision by applying one of two standards of review: "de novo" or "abuse of discretion."[136] De novo review will be used when "the validity of the tax liability was property at issue in the hearing, and where the determination with regard to the tax liability is part of the appeal."[137] The "abuse of discretion" standard of review will be used when the tax liability itself is not being appealed.[138]

In the *Medlock* case, the court applied an "abuse of discretion" standard of review, finding a reversible error by the IRS representative.[139] Since the tax liability itself was not at issue in this case, the court required the taxpayer to satisfy a higher burden of proof on appeal.[140] In cases where an abusive tax shelter is found, most cases will end up being reviewed under this "abuse of discretion" standard, making it more difficult to avoid liability when caught.[141] Abuse of discretion review will also occur when money laundering has led to tax evasion, and the tax liability of that transaction is in question.[142]

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finally to sell her day care business to her mother was not in the interest of the efficient collection of taxes.").

[133] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984).

[134] *Id.* at 843.

[135] *Id.* at 844.

[136] Goza v. Comm'r, 114 T.C. 176, 181 (2000) (citing H.R. REP NO. 105-599, at 266 (1998) (Conf. Rep.)).

[137] H.R. CONF. REP. NO. 105-559, at 215 (1998).

[138] *Id.* ("Where the validity of the tax liability is not properly part of the appeal, the taxpayer may challenge the determination of the appeals officer for abuse of discretion.").

[139] Medlock v. United States, 325 F. Supp. 2d 1064, 1078 (C.D. Cal. 2003).

[140] *See id.*

[141] *See id.* (In cases involving an abusive tax shelter, the tax liability will generally be contested, especially if it was not intentional abuse.).

[142] *See id.* The court will analyze any tax liability issues under an abuse of discretion standard. If the money launderer has disputed tax liability, the finding of liability will be analyzed on appeal under the abuse of discretion standard. If only the origin of the funds or the total use of the funds is in question, the appellate court

IV. WHAT IS MONEY LAUNDERING?

One commonly known means of abusing the tax system is money laundering. This is a process where money moves to different areas so the original source cannot easily be ascertained.[143] This system is often used to hide funds that were the result of illegal activity, such as drug trafficking or embezzlement.[144] People launder money in an effort to make the proceeds of illegal actions seem legitimate.[145] Much of the recent legislation is meant to prevent international money laundering.[146] Money laundering can also be done within the United States through shell corporations, potentially reducing the legitimate use of these entities.[147]

A. *International Money Laundering*

There are three steps for laundering money: placement, layering and integration.[148] Placement is "changing the money derived from criminal activities into an easily manipulated and/or less suspicious form, culminating in the introduction of the funds into the mainstream financial system."[149] Layering is a "wire transfer of funds through numerous accounts in an attempt to hide the funds' true origins."[150] Integration is when the layered funds are moved "into the global financial world to be mixed with funds of legitimate origin."[151]

The efforts to combat money laundering have historically relied on detecting the deposits of large sums of cash both around the world and

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will review the decision de novo. *Id.* at 1076. *See also* United States v. English, 92 F.3d 909, 916 (9th Cir. 1996).

[143] 18 U.S.C. § 1956(a)(1)(B)(i) (2006).

[144] *Id.* § 1956(c)(7)(B).

[145] Tracy Tucker Mann, *Money Laundering*, 44 AM. CRIM. L. REV. 769, 769 (Spring 2007) ("Money laundering is 'the process by which one conceals the existence, illegal source, or illegal application of income, and disguises that income to make it appear legitimate.'").

[146] *See* 18 U.S.C. § 1956 (increasing the reporting requirements for overseas transactions); 31 U.S.C. § 5311 (2006) (new amendments meant to stop money laundering to stop terrorism); 31 U.S.C. § 5313 (2006) (requiring additional reporting requirements for domestic deposits).

[147] 1 STUART R. COHN, SECURITIES COUNSELING FOR SMALL & EMERGING COMPANIES § 10:10 (2010).

[148] Scott Sultzer, Note, *Money Laundering: The Scope of the Problem and Attempts to Combat it*, 63 TENN. L. REV. 143, 148 (1995).

[149] *Id.*

[150] *Id.* This usually occurs through offshore bank accounts, but that is not entirely necessary.

[151] *Id.* at 148–49.

domestically.[152] In 1993, money laundering hid over $750 billion worldwide in over 125 countries.[153] Of this sum, around $300 billion was located in the United States.[154] This fact has led to many legislative efforts to combat the spread of money laundering.[155]

B. *Legislation Combating Money Laundering*

Early statutory attempts to combat money laundering combatted the use of money laundering by organized crime outfits.[156] Originally passed in 1970, the Racketeer Influenced and Corrupt Organizations Act ("RICO") primarily focused on punishment for engaging in racketeering while committing one of several listed felonies.[157] Money laundering is one of these crimes, but RICO was not specifically designed to stop money laundering.[158]

The first effort to target money laundering specifically came with the Money Laundering Control Act of 1986.[159] This act was designed to "permanently taint the proceeds of criminal activity with a scarlet letter."[160] The statute defined money laundering as "knowing that the transaction is designed in whole or in part (i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or (ii) to avoid a transaction reporting requirement under State of Federal law."[161]

There are several ways to violate the act. One way is that a person knows that a financial transaction is made with proceeds of an unlawful activity and is designed "to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity; or to avoid a transaction reporting requirement."[162] It is also illegal to move money either to or from the United States with the intent of carrying on unlawful activity or knowing that the money is from unlawful

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[152] *Id.* at 152 (citing 31 U.S.C. § 5311(2006)).
[153] Sultzer, *supra* note 148, at 145–46 n.3.
[154] *Id.* at 146.
[155] *See* Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961–63 (2006); Money Laundering Control Act, 18 U.S.C. § 1956 (2006).
[156] *See* 18 U.S.C. § 1962 (2006).
[157] 18 U.S.C. § 1961(1) (listing both state and federal felonies that will fall under the definition of "racketeering activity").
[158] *Id.*
[159] 18 U.S.C. § 1956 (2006).
[160] Theodore A. Sinars & Richard L. Manning, *Money Laundering*, *in* 15 MERTENS LAW OF FEDERAL INCOME TAXATION § 55A: 38 (2011).
[161] 18 U.S.C. § 1956(a)(1)(B)(i)–(ii).
[162] 18 U.S.C. § 1956(a)(1)(B). A financial transaction is defined as "one involving the proceeds of specified unlawful activity, and all of which are part of a single plan or arrangement." *Id.*

activity.[163] Either one of these actions will result in a fine of up to either "$500,000 or twice the value of the monetary instrument or funds involved . . . whichever is greater."[164]

Newer efforts to combat money laundering have focused on the reporting requirements for banks.[165] Banks are required to report any transactions that the Secretary of the Treasury deems should be reported.[166] The bank must disclose who is making the transaction, and if that depositor is an agent, the agent must disclose that information.[167] The agent making a transaction must also identify the principal behind the transaction.[168] Other

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[163] 18 U.S.C. § 1956(a)(2)(A)–(B):

> Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer monetary instruments or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States (A) with the intent to promote the carrying on of specified unlawful activity; or (B) knowing that the monetary instrument or funds involved in the transportation, transmission, or transfer represent the proceeds of some form of unlawful activity and knowing that such transportation, transmission, or transfer is designed in whole or in part (i) to conceal or disguise the nature, the location, the source, the ownership, or the control of the proceeds of specified unlawful activity or (ii) to avoid a transaction reporting requirement under State or Federal Law.

Id.

[164] 18 U.S.C. § 1956(a).

[165] 31 U.S.C. § 5313(a) (2006).

[166] *Id.*

[167] *Id.*

> When a domestic financial institution is involved in a transaction for the payment, receipt, or transfer of United States coins or currency (or other monetary instruments the Secretary of the Treasury prescribes), in an amount, denomination, or amount and denomination, or under circumstances the Secretary prescribes by regulation, the institution and any other participant in the transaction the Secretary may prescribe shall file a report on the transaction at the time and in the way the Secretary prescribes. A participant acting for another person shall make the report as the agent or bailee of the person and identify the person who whom the transaction is being made.

Id.

[168] *Id.* There is also a "Qualified Business Customer" exemption, which requires that the business maintains a transaction account with the depository, frequently engages in transactions with the depository which would be reported, and meet other criteria determined by the Secretary of the Treasury. *Id.* § 5313(e)(2)(A)–(C).

exemptions to this reporting requirement include businesses whose reports would have little or no value for law enforcement purposes.[169]

C. *Use of Shell Corporations in Money Laundering*

Many people believe shell corporations allow for money laundering. A shell corporation is one that has no operations or assets.[170] These can be set up by public corporations as part of a merger.[171] When this occurs, it is usually in a process called a "reverse merger" or "going public through the back door."[172]

Many publicly traded shell corporations exist. These companies merge with private companies to provide enough liquidity to go public.[173] The publicly traded shell corporation does not need to have been created as a subsidiary.[174] A public corporation can be created even though it has no assets and no formal operations.[175] Also, a corporation could become a shell corporation if the corporation loses all assets that it once held and no longer does business as a corporation.[176]

Possible problems could arise during the merger of a shell corporation. The first problem could arise if there are hidden liabilities or claims that could not attach to the corporation because of the lack of assets.[177] Also, though the ability to "go public through the back door" can have many monetary benefits, there could be reporting requirements that come into play if certain thresholds are met.[178] If this merger is done to increase

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[169] 31 U.S.C. § 5313(d)(1)(D).

[170] 17 C.F.R. § 240.12b-2 (2010). The terms shell company means a:

> [R]egistrant, other than an asset-backed issuer as defined in Item 1101(b) of Regulation AB, that has: (1) No or nominal operations; and (2) Either: (i) no or nominal assets; (ii) Assets consisting solely of cash and cash equivalents; or (iii) Assets consisting of any amount of cash and cash equivalents and nominal other asset.

Id.

[171] COHN, *supra* note 147, at 1.

[172] *Id.* When a private company merges into a public shell, "the principals in the former private company are issued shares in the public shell sufficient for them to be controlling shareholders. Those owners not only have control of a public company, they will have liquidity for their shares if an active trading market develops." *Id.*

[173] *Id.*

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] *Id.*

[178] *Id.* (noting that under the 1934 Act, the company will have to make follow reporting requirements if it has 500 shareholders and $10 million in assets. If this is met, a Form 8-K must be filed.).

liquidity, it may not work because the sale of newly distributed shares could be restricted.[179]

Despite these potential problems, the use of shell corporations can allow private corporations to almost immediately increase the value of their corporations.[180] An investigation into a public corporation involved in a non-subsidiary merger will be able to show any claims waiting to attach to assets when they become available.[181] This will be a necessary step in the due diligence investigation of any merging corporation. Also, if the owners do not need the shares of the new corporation to be immediately liquid, going public through the back door will allow the previously private-corporation to avoid paying the costs associated with a public registration.[182]

V. HOW CAN A TAX SHELTER BENEFIT A SMALL BUSINESS OWNER?

Tax shelters were created to give select business owners or individuals tax advantages when operating their businesses in order to keep their costs down and encourage entrepreneurs to start new businesses.[183] The tax benefits are created for the legitimate purpose of allowing new businesses to be formed at a lower cost.

Corporation soles, for example, were created for only the narrow purpose of allowing qualified religious organizations to maintain their organizations beyond the life of the current leader.[184] There is a very limited, but legitimate, interest in allowing these leaders to ensure the longevity of their churches.[185] A corporation sole gives preferential treatment to religious organizations beyond the protections of either an LLC or a corporation.[186]

The LLC is one of the most interesting developments for small business owners. LLCs allow for hidden ownership and limited liability for the

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[179] *Id.* COHN, *supra* note 147, § 6:9.

[180] COHN, *supra* note 147 ("It has been estimated that the value of being a public company is worth $150,000 to $500,000, and that value is often reflected by the shell corporation shareholders receiving fifteen to twenty percent of the shares of the merged entity.").

[181] *See* GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS § 4.04 (2010).

[182] COHN, *supra* note 147.

[183] *See generally* Kathleen Bicek Bezdichek, *Validity, Construction, and Application of § 6700 of the Internal Revenue Code (26 U.S.C.A. § 6700) Imposing Civil Penalties for Promoting Abusive Tax Shelters*, 36 A.L.R. Fed. 2d 377 (2009).

[184] Bassett et al., *supra* note 45.

[185] *Id.*

[186] *Id.*

business entity.[187] The benefits of LLCs are often seen as a means of holding and conveying real estate.[188] Real estate owners can convey their interest to an LLC so the owners can receive tax advantages by avoiding state real estate transfer taxes.[189] The LLC gives minimal consideration to the seller, while the LLC, which is managed by the buyer, wholly owns the property.[190] Recently, states have begun to change the law to prevent these types of transactions.[191] For other states, their legislatures have decided that the cost saving benefits of these changes exceed lost revenues typically associated with driving new businesses to other states.[192]

LLC ownership also does not need to be disclosed.[193] This advantage allows for reduced costs in the formation and the ability to secretly run a private company.[194] There are several legitimate reasons to want secret ownership of an LLC, such as keeping the LLC from becoming a target for takeover.[195] However, secret ownership also sets the stage for the availability of fraud, including increased ability to hide personal funds.[196] Several laws have been proposed to mandate the disclosure of the leaders of LLCs in an effort to combat the problems with abusive tax shelters and money laundering.[197] As government agencies focus more attention on LLCs in general, the likelihood of an audit can increase, thus increasing the expected costs of creating a business.[198]

There are several factors beyond taxes that need to also be considered before entering any kind of tax shelter. The first of these is the cost of having an audit performed voluntarily. Voluntary audits, even for very

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[187] Paul A. Hedstrom, *Slow Down: Is the LLC Becoming a Less Appealing Vehicle for Conveying Real Estate?*, 24 PROB. & PROP. 37, 38 (2010).
[188] *Id.* at 37.
[189] *Id.*
[190] *Id.*
[191] *Id.* at 38. States have begun to tax the transfer of property. As a result, the states with increased taxes will experience reduced business inflow as businesses look to incorporate in more favorable climates.
[192] *Id.*
[193] *See* DEL. CODE ANN. tit. 6, § 18-201 (1995) (requiring only the name of the LLC, an address, an agent for service of process, and anything else the LLC determines needs to be provided).
[194] Verret, *supra* note 109, at 890.
[195] *Id.* (noting that privacy is needed not only because it "impacts purchase prices for target companies, but also purchase prices for target assets, particularly real estate.").
[196] *Id.* at 858.
[197] *See* Stop Tax Haven Abuse Act, S. 506, 111th Cong. §§ 306–07 (2009); Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. (2009).
[198] *Need a Loan? Get an audit*, OHIO SOCIETY OF CPAS (Jan. 19, 2011), http://www.ohioscpa.com/PublicArticle.aspx?ID=2491.

small businesses, will costs thousands of dollars.[199] Anybody considering creating a business while using a potentially abusive tax shelter should factor this cost into their decision of whether the tax shelter will create the benefits they desire.[200] These costs do not even include the risk of an IRS audit, which have been performed more frequently on small businesses in recent years.[201] These audits, even if no violations are found, can cost tens of thousands of dollars.[202] Though it is not a guarantee that a small business will get audited, the more red flags a company has, the more likely it will be audited.[203] Also, as the necessity for people in bigger companies to whistle blow increases, this trend is likely to continue.[204] Currently, whistle blowing is only required for large corporations,[205] but those in smaller corporations are protected if they choose to blow the whistle on any illegal action.[206]

VI. WHAT LAWS ARE IN PLACE TO PROTECT LEGITIMATE TAX SHELTERS?

A. *Current Law*

State laws create the ability for an individual or group to form a business. As a result, it is important to understand the differences between business formation laws in states to understand how the law can both aid legitimate businesses and prevent abuse.

In Delaware, to form an LLC, a founder only needs: (1) a name for the company, (2) the name and address for the agent for service of process, and

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[199] *Id.* "A small-business audit costs anywhere from $5000 to $75,000, depending on the size of the company, the complexity of its data and other factors . . . ."

[200] *Id.*

[201] Ian Mount, *IRS Small-Business Audits Increase*, CNNMONEY.COM (June 3, 2008), http://money.cnn.com/2008/05/20/smallbusiness/irs_audits.fsb/index.htm ("[T]he smallest companies saw the taxman 41% more often in 2007 than in 2005.").

[202] *See id.*

[203] *Id.*

[204] *Id.* The IRS has caught big businesses recently through audits created by whistleblowers instead of random selection by the IRS.

[205] *See* Sarbanes Oxley Act of 2002 §301(4), 15 U.S.C. § 78j-1.

[206] 31 U.S.C. § 3730(h) (2006).

(3) any other matters the members determine to include."[207] In contrast, Ohio requires filing: [208]

> (1) [t]he name of the company; (2) [e]xcept as provided in division (B) of this section, the period of its duration, which may be perpetual; (3) [a]ny other provisions that are from the operating agreement or that are not inconsistent with applicable law and that the members elect to set out in the articles for the regulation of the affairs of the company.[209]

An important difference between Delaware law and Ohio law is that in Ohio, there is no freedom of contract language.[210] In Delaware, the courts are required by statute to defer to the parties' freedom to contract when enforcing an agreement.[211] This will encourage fewer people to organize an LLC in Ohio because there is a greater chance that a court will enforce terms not agreed to by the parties. A business that does not want terms forced upon the LLC can create the LLC in Delaware and write a specific operating agreement stating the rights of the members in addition to any other terms it wishes to include.[212]

The Ohio Revised Code requires that the operating agreement of an LLC be filed with the Secretary of State,[213] while the Delaware statute does not.[214] Both states require that the name of the agent for an LLC be filed with the Secretary of State, but this is for service of process only;[215] the privacy of the structure of the LLC still remains in Delaware. These

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[207] DEL. CODE ANN. tit. 6, § 18-201(a) (2010). A company agreement must also be reached, but this can be done before or after the initial formation of the company. If it is created after the formation of the company, then it may be ratified to have been effective the entire time. *Id.* § 18-201(d).

[208] Ohio is an example of a state considered to have more stringent formation requirements for LLCs.

[209] OHIO REV. CODE ANN. § 1705.04(A)(1)–(3) (West 2010). Division (B) states "[i]f the articles of organization or operating agreements do not set forth the period of the duration of the limited liability company, its duration shall be perpetual." *Id.* § 1705.04(B).

[210] *See* Wis-Bay City, LLC v. Bay City Partners, LLC, 3:08 CV 1730, 2009 WL 1661649, at *6 (N.D. Ohio June 12, 2009) ("However, the Ohio Supreme Court has limited this principle, noting that '[i]n certain circumstances . . . complete freedom of contract is not permitted for public policy reasons. One such circumstance is when stipulated damages constitute a penalty.")

[211] *See* DEL. CODE ANN. tit. 6, § 18-1101(b) (2010).

[212] *See id.* § 18-1101(e).

[213] OHIO REV. CODE ANN. § 1705.04(A)(3).

[214] DEL. CODE ANN. tit. 6, § 18-201(a).

[215] OHIO REV. CODE ANN. § 1705.06(C) (West 2010); DEL CODE ANN. tit. 6, § 18-201(a)(2).

relaxed standards allow for more privacy in Delaware LLCs compared to Ohio LLCs.

Nevada's requirements are somewhere between the relaxed requirements of Delaware and the strict requirements of Ohio. In Nevada, one or more persons are needed to form an LLC, but they need not be members of the LLC.[216] However, the articles themselves are not enough for an LLC to be formed.[217] There must always be at least one member in the LLC to remain a business.[218] Nevada requires the filing of:

> (a) The name of the limited-liability company; (b) [The registered agent of the LLC]; (c) The name and address, either residence or business, of each of the organizers signing the articles; (d) If the company is to be managed by: (1) One or more managers, the name and address, either residence or business, of each initial manager; or (2) The members, the name and address, either residence or business, of each initial member; (e) If the company is to have one or more series of members and the debts or liabilities of any series are to be enforceable against the assets of that series only and not against the assets of another series or the company generally, a statement to that effect . . . .[219]

Nevada law requires more information than is required in Delaware, but is more lenient than the requirements in Ohio. However, in Nevada there is no requirement to file any information regarding the names of any members of the LLC, or even the acting managers.[220]

These differences generally do not arise with corporation sole laws, though corporation sole organizations have resulted in increased fraud. A corporation sole will have the same basic form in any state that still recognizes the status.[221] Utah had to eliminate the corporation sole because abuse was too prevalent.[222] The tax benefit from fraudulent corporation sole organizations cost the state too much money; however, the repeal hurt

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[216] NEV. REV. STAT § 86.151 (2010).
[217] *Id.*
[218] *Id.*
[219] NEV. REV. STAT. § 86.161 (2010).
[220] *Id.* The manager filed only needs to be the initial manager, so an attorney filing (or the agent of the LLC) could be listed in the initial position, then change the manager after formation to maintain privacy of the ownership.
[221] Bassett et al., *supra* note 45. In 2004, there were only sixteen states that still recognized the corporation sole. *Id.*
[222] *Id.* (The ban occurred in 2004.).

both legitimate and illegitimate uses of the law.[223] Even for the states that do have a corporation sole, it only has a limited use and cannot be used like a 501(c)(3) corporation.[224] As a corporation sole, the organization will be an entity itself.[225] This will grant the corporation sole the powers similar to any other legal entity,[226] and perpetual existence in the future.[227] Despite these legitimate interests, the goals of LLC and corporation sole laws are being threatened by proposed federal laws.[228]

B. *Proposed Law*

Two bills have been proposed in Congress recently.[229] The first bill, the Stop Tax Haven Abuse Act,[230] was in several committees of the House of Representatives before the new Congress took power in January.[231] This bill aimed to prevent the use of offshore tax havens and the abuse of onshore tax shelters.[232] The second bill, the Incorporation Transparency and Law Enforcement Assistance Act,[233] was in the Senate Committee on

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[223] *Id.*

[224] Rev. Rul. 2004-27, 2004-1 C.B. 625.

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3) (2006).

[225] NEV. REV. STAT. § 84.040 (2010).

[226] *Id.* § 84.050 (2010).

[227] *Id.* § 84.040.

[228] *See* Stop Tax Haven Abuse Act, S. 506, 111th Cong. §§ 306–07 (2009); Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. §§ 306–07 (2009).

[229] S. 506, 111th Cong. §§ 306–07.

[230] *Id.*

[231] *Id.* The bill was referred to the House Ways and Means committee, the House Financial Services Committee, and the House Judiciary Committee. The Judiciary Committee then referred it to the Subcommittee on Courts and Competition Policy.

[232] *Id.*

[233] *Id.*

Homeland Security and Governmental Affairs during the last Congress.[234] One purpose of this bill was to ensure "persons who form corporations in the United States disclose the beneficial owners of those corporations, in order to prevent wrongdoers from exploiting United States corporations for criminal gain, to assist law enforcement in detecting, preventing, and punishing terrorism, money laundering, and other misconduct involving United States corporations . . . ."[235]

1. *The Stop Tax Haven Abuse Act*

The Stop Tax Haven Abuse Act[236] included measures that could prevent the use of illegitimate offshore tax havens and onshore tax shelters. First, the bill was designed to increase the communication between several different government entities.[237] It would also codify and strengthen the economic substance doctrine to invalidate transactions that have no meaningful economic substance or business purpose apart from tax avoidance.[238] A transaction is defined as having economic substance if "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[239] This definition requires that the deal must improve the status of the taxpayer in an objective way.[240] Moreover, the bill would ensure that company formation agents comply with anti-money laundering obligations.[241] This goal would be attained by allowing the Secretary of the Treasury to make rules as needed to reduce money laundering.[242]

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[234] *Id.*; S. 569, 111th Cong. §§ 306–07.
[235] S. 569, 111th Cong. §§ 306–07.
[236] S. 506, 111th Cong. §§ 306–07.
[237] *Id.* §§ 306–07.
[238] *Id.* §§ 401–03.
[239] I.R.C. § 7701(o)(1)(A)–(B) (repealed 2011). (This provision has been repealed, but this does not substantively affect this analysis of the Stop Tax Haven Abuse Act).
[240] Coltec Indus., Inc. v. United States., 454 F.3d 1340, 1359 (Fed. Cir. 2006).
[241] S. 569, 111th Cong. §§ 306–07.
[242] *Id.* (proposing to add 31 U.S.C. § 5312(b) (2006)). This statute states:

> Deadline for Anti-Money Laundering Rule for Formation Agents—Not later than 90 days after the date of the enactment of this Act, after consulting with the Attorney General of the United States, the Commissioner of the Internal Revenue Service, and Chairman of the Securities and Exchange Commission, the Secretary of the Treasury shall public a proposed rule in the Federal Register requiring persons described in section 5312(a)(2)(Z) of title 31, United States Code, as added by this

There were several problems with the Stop Tax Haven Abuse Act. First, it would not be directly binding on foreign countries.[243] The bill instead created "rebuttable evidentiary presumptions" for investments located in offshore secrecy jurisdictions.[244] These presumptions included that the transfer of income either to or from an offshore secrecy jurisdiction is previously unreported income.[245] Also, if a person received a distribution or gave income to the offshore secrecy jurisdiction, they would be presumed to have had control over it.[246] These presumptions are believed to be necessary because it would be extremely difficult and costly to receive the actual information of account holders in these offshore secrecy jurisdictions.[247]

Additionally, this bill does not provide for "automatic information exchange agreements" with the offshore secrecy jurisdictions.[248] An automatic information exchange would allow the IRS to know who is investing in overseas accounts without having to investigate or rely on self-reporting by the taxpayer.[249] This precludes an effective information exchange practice with offshore secrecy jurisdictions.[250] The difficulty in

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> section, to establish anti-money laundering programs under subsection (h) of section 5318 of that title. The Secretary shall publish such rule in final form in the Federal Register not later than 180 days after the date of the enactment of this Act. 5312(a)(2)(Z) would be 'persons involving in forming new corporations, limited liability companies, partnerships, trusts, or other legal entities.'

31 U.S.C. § 5312(b).

[243] Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. §§ 306–07 (2009); Bruce Zagaris, *Enforcement Issues in Offshore Planning: The Practitioner Increasingly Squeezed by Overlapping and Conflicting Laws and Ethics*, *in* INTERNATIONAL TRUST AND ESTATE PLANNING 239, 265 (2010).

[244] *Id.*

[245] *Id.* The other presumptions are that if a person received benefits from the offshore secrecy jurisdiction, the taxpayer has exercised control over the account, the taxpayer beneficially owns the account, and if the account had over $10,000, the reporting requirement is triggered.

[246] *Id.* Having contact with an offshore secrecy jurisdiction will also result in presumed beneficial ownership of the account. *Id.* Also, instead of the previous threshold of $10,000 for a foreign account to trigger reporting, any offshore secrecy jurisdiction account will need to be reported. *Id.*

[247] *Id.*

[248] *Id.*

[249] Zagaris, *supra* note 243, at 265.

[250] *Id.* There are three elements that the Treasury Secretary must determine annually to find an effective information exchange practice:

> (1) the jurisdiction is party to an agreement that has a 'prompt, obligatory, and automatic' information exchange agreement; (2) the exchange of information has been, during the last 12 months,

implementing a world-wide tax notification system has created a situation where the law looks to punish only those that enforcement officers can actually find with offshore accounts.[251] Without an automatic information exchange, or any kind of quick information exchange, this bill would only penalize the people that were willing to report these accounts.[252] This bill would be ineffective because it relied on self-reporting instead of creating treaties with countries to ensure the "prompt, obligatory, and automatic" exchange of information.[253]

2. *The Incorporation Transparency and Law Enforcement Assistance Act*

The other important newly proposed bill, the Incorporation Transparency and Law Enforcement Assistance Act, would mandate the disclosure of LLC and corporation beneficial owners.[254] A beneficial owner is defined in the bill as "an individual who has a level of control over, or entitlement to, the funds or assets . . . that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the corporation or limited liability company."[255] If the business entities do not keep track of these beneficial owners, the bill would require a $10,000 fine and possibly a prison sentence.[256] The stated purpose for these changes to beneficial owner information disclosure was to prevent terrorist activities within the United States.[257]

Several loopholes in this bill would prevent it from solving the problems it set out to fix.[258] The bill specifically required beneficial

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> adequate to prevent evasion or avoidance of U.S. tax; and (3) the jurisdiction, during the last 12 months, was not identified by an intergovernmental group of which the U.S. is a member (e.g., the OECD) as uncooperative with international tax enforcement or information exchange (and the U.S. concurs).

Id.

[251] *Id.*

[252] *Id.* at 266–67. Another important bill in offsetting offshore tax havens has been the Foreign Account Tax Compliance Act, which has been enacted. This bill penalizes foreign banks that do not report account holders to the United States.

[253] *Id.*

[254] Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. (2009).

[255] *Id.*

[256] Verret, *supra* note 109, at 859.

[257] S. 569.

[258] Verret, *supra* note 109, at 860. Also, the burden of this bill would not fall on those trying to break the law, but rather those who are willing to give their information. Criminals could also get other beneficial owners so they still do not get disclosed, usually through the use of a straw man. *Id.* at 862.

ownership information to be maintained by states for corporations or LLCs, but did not make the same requirement for limited liability partnerships (LLPs), non-profits, or other business entities.[259] This provision would encourage people who want to avoid taxes, or who just want to keep costs down, to use different business formations.[260] Also, people still wanting to use a certain business form, but also wanting to maintain privacy, could have had a straw man claim to have beneficial ownership.[261] The definition of beneficial control could have led to people without control being listed as a beneficial owner, possibly affecting the value of the company.[262]

Even Delaware has not been consistent about what constitutes a beneficial owner.[263] The simpler the definition of beneficial owner, the easier it will be to subvert.[264] If the wording is broader, the problem with actual ownership will decrease, but there will be more people subjected to ownership liability, including estates of shareholders or even credit card companies lending to businesses.[265] At this time, stock ownership is not enough to show control of a corporation.[266]

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[259] S. 569.

[260] Verret, *supra* note 109, at 860.

[261] *Id.* at 862.

[262] *Id.* at 865. The article mentions a system where a staggered board could result in no control from majority shareholder because he could not vote out the board with one election. *Id.*

[263] *In re* Cysive, Inc. S'holder Litig., 836 A.2d 531, 552 n.30 (Del. Ch. 2003) (holding that a forty percent shareholder was the controlling party because of "the fact that a 100% turn-out is unlikely even in a contested election . . . . A 40% block is very potent in view of that reality."); *but see* Kahn v. Lynch Commc'n. Sys., Inc., 638 A.2d 1110, 1114 (Del. 1994):

> Shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.

Id. *See* DEL. CODE ANN. tit. 8, § 203(c)(4) (2010) ("[A] person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary.").

[264] Verret, *supra* note 109, at 874.

[265] *Id.* at 872.

[266] *See* 17 C.F.R. § 240.12b-2 (2010) (Control is "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.").

The costs associated with this bill could also prove to be extremely high for states because of the duty to monitor.[267] This cost will be even greater for extremely complex LLCs.[268] The structure of many legitimate LLCs make it very difficult to determine who exactly is the beneficial owner.[269] The bill would require states to keep detailed records of beneficial owners of corporations and LLCs.[270] These state records would be very difficult to maintain, and states would still need to attempt to track all illegal activity occurring in corporations or LLCs within the state.[271]

The bill also required the voluntary disclosure of ownership information.[272] As a result, wrongdoers would not be found naturally by the system.[273] If the bill requires too much invasion of current privacy, people who want to fund terrorist acts or launder money will use other means.[274] States could also pass their own legislation to keep the ownership information private.[275] This privacy can affect the value of the company or the ability for entrepreneurs to start new businesses.[276]

One element noticeably absent from both bills was the increase in education about these topics. The ability to educate those using tax shelters about what constitutes abuse will be necessary to limit unintentional abuse in the future. Without a plan of how to realistically get people to understand these new rules, tax shelters will continue to be abused at some level.

VII. HOW SHOULD THE CURRENT SYSTEM CHANGE TO BETTER ENABLE THE USE OF THESE TAX SHELTERS WHILE STILL PREVENTING ILLEGAL ACTIVITY?

The proposals made thus far will not solve the problem of abusive tax shelters. Instead, the likely effects will lead many law abiding citizens to stop performing perfectly legal activities, thereby stifling economic

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[267] Verret, *supra* note 109, at 864.
[268] *Id.*
[269] *Id.* at 865. There could be situations where the varying structures of individual businesses make it difficult to ascertain a beneficial owner, especially when a majority shareholder may or may not control the company.
[270] *Id.* at 859.
[271] *Id.*
[272] *Id.* at 865.
[273] *Id.* at 878. The law was designed "to assist law enforcement in detecting, preventing, and punishing terrorism, money laundering, and other misconduct." *Id.* at 877.
[274] *Id.* at 880.
[275] *Id.* at 890.
[276] *Id.*

growth.[277] Tax shelters are created in order to encourage investment and businesses formation by select groups.[278] The abuse by a very limited minority should not result in the loss of tax benefits for every participant, especially those initially starting a business. The additional costs being suggested in the current litigation could be a burden on entrepreneurs trying to form a business with very little cash.[279] These entrepreneurs will be unable to get their products or services out to the public because increased initial costs prevent them from ever starting their businesses.[280]

The government cannot realistically decide which businesses are legitimate and which ones should be forced to disclose more information. On one level, this decision would simply cost too much money to be an effective system. Additionally, the only way the government could gather that information would be to determine what every business organization is doing either by requiring business filings, or forcing unwanted audits.[281] If the control requirement is made lighter, it will become easier for those trying to use an abusive tax shelter to subvert the law.[282] These current proposals will not stop tax shelter abusers from achieving their desired goals of tax reduction or avoidance while still allowing legitimate businesses to continue.[283]

The best way to stop the unintentional abuse of tax shelters is to educate people about taxes and tax shelters generally. Education needs to be for both non-professionals and professionals in the field. It is important that everyday people learn to understand, at least at a basic level, which entities and tax shelters are allowed and which ones are illegal. By funding continuing education programs and encouraging this information to be taught in both high school and college, the government can reduce the abuse of tax shelters by people who may otherwise believe all of the advice of a tax shelter promoter.

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[277] DeLee, *supra* note 5, at 437. Tax shelters are legal when used properly.

[278] *Id.* at 433.

[279] Verret, *supra* note 109, at 864.

[280] *Id.* at 865. The additional costs being added include disclosure of beneficial owners (including determining who is a beneficial owner) and additional filings for activity over $10,000.

[281] *Id.* These would also increase the costs of businesses of all kind, causing the same problems listed above.

[282] *Id.* at 874. People attempting to break the law could also use trusts for illicit purposes or have the trusts form business entities and allow the trust to be the beneficial owner. *Id.* at 873.

[283] *Id.* at 878. The law assumes that criminals will voluntarily disclose the information of their illicit business dealings to the government simply because the law tells them to do so. Instead, the author believes that they will find new ways to circumvent the tax laws of the United States, including investing in different banks, most notably Hawala banks. *Id.* at 880.

Promoters of tax shelters, generally accountants and attorneys, should be trained more extensively about tax shelters. One possible solution would be to require a promoter to register with the government before encouraging certain tax shelters to clients. Further, the government should allow for certification as a tax promoter. For a fee, anybody could register as a tax promoter. In order to become certified, that person must perform coursework about tax shelters and then pass a test concerning abusive tax shelters. There should also be continuing coursework about new tax shelters so the certified promoters know the current law and any potential upcoming changes. The promoters would need to declare themselves as either registered or certified, and certification would require renewal after a certain period. Anybody that promotes a tax shelter will be subjected to the current laws concerning tax shelter promotion.[284] The fees from these programs and registrations would supplement the governmental costs for implementing this program.

In addition to more education, both the promoters and taxpayers that abuse tax shelters should face increased penalties for their actions. The current penalty is either a maximum of a $1000 fine or the value of the gross income derived from the plan.[285] This penalty can be relatively small if the tax shelter derives a high enough gross income.[286] Instead, the penalty should always be the income derived from the tax shelter. Additional fines and penalties can also be applied to create an incentive to not participate in these plans. By increasing the penalty for being caught having an abusive tax shelter, the business owner will more accurately be able to factor the cost of the risk into the decision to use any kind of tax shelter. Though this plan could increase the compliance costs of the entrepreneur, cost increases can be reduced by choosing a safer tax structure that will not trigger any red flags for a potential IRS audit.[287]

If somebody is promoting an abusive tax shelter, and that person is not registered or certified to promote tax shelters, that person should face an additional penalty. The promoter should be held to the same standards as a professional giving the advice, plus additional fines or jail time for practicing without the proper credentials. These increased penalties will be necessary to ensure that people trying to subvert the law will not have economic incentive to do so. The additional penalty should be applied even

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[284] *See* I.R.C. § 6700 (2006). These requirements would still need to be met under this proposed system.

[285] *Id.* § 6700(a) (Any person participating or organizing an abusive tax shelter "shall pay, with respect to each activity described in paragraph (1), a penalty equal to the $1000 or, if the person establishes that it is lesser, 100% of the gross income derived (or to be derived) by such person from such activity.").

[286] *Id.* (restricting the maximum fine to only $1000).

[287] Mount, *supra* note 201.

if a legal tax shelter is promoted, but merely promoted by an unregistered agent. Implementing this rule would not dramatically increase the cost of creating a business because the registration or certification could easily be checked by the business creator through minimal research. This change would merely ensure that only registered or certified people are promoting tax shelters, which would allow abusive tax shelters to be more easily traced to a certain group of individuals. This change will not be able to prevent all abusive tax shelters from occurring, but it can reduce the prevalence of abuse. Those people that want to avoid taxation will still find new ways to create abusive tax shelters.[288]

In order for these changes to be effective, they would need the endorsement of bar associations and CPA groups. These groups can have better control in ensuring their members understand the law both now and in the future. In addition, more stringent penalties can be imposed by these groups to make the members fully understand the consequences of their actions. This additional cooperation will still not catch every person trying to utilize an abusive tax shelter, but it will reduce the number of people willing to try to promote tax shelters, and will reduce the willingness of people to abuse tax shelters.

VIII. CONCLUSION

Tax shelters are designed to give tax benefits to people trying to start or continue businesses or investments. Many people have started to abuse these tax shelters, preventing legitimate entrepreneurs and investors from receiving the desired protections.[289] The IRS has sent several warnings to protect against abusive tax shelters,[290] but no effective regulation has been passed or proposed.[291] In order to prevent tax shelters from being abused while still allowing small business owners to utilize the benefits of tax shelters, more stringent penalties and training need to be enforced against people trying to promote abusive tax shelters. These additional penalties will allow the legitimate uses to still continue as desired, while preventing the spread of abuse. Though these proposed changes cannot stop all abuses,[292] they will be effective in reducing the spread of abusive tax

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[288] Verret, *supra* note 109, at 880. Terrorists will likely use Hawala banks instead of United States banks in order to hide funds if it becomes too difficult in the United States. *Id.*

[289] DeLee, *supra* note 5, at 433.

[290] *See* I.R.S. News Release IR-04-26, *supra* note 40; I.R.S. New Release IR-2004-42, *supra* note 49.

[291] Stop Tax Haven Abuse Act, S. 506, 111th Cong. §§ 306–07 (2009); Incorporation Transparency and Law Enforcement Assistance Act, S. 569, 111th Cong. (2009).

[292] Verret, *supra* note 109, at 880.

shelters while simultaneously promoting the growth of small businesses throughout the country.